Securitisation[1] and Currency Hedging under Islamic Shafi Law: Part 1

By Professor Andrew Haynes[2] and Dr Calvin Reis-Roy[3]

Introduction

In essence secondary securitisation[4] consists of issuing bonds from a separate company from that originating the process. This second company (a special purpose vehicle or "SPV") cannot be subsidiary of the first and must be a distinct, free standing entity. This SPV will be thinly capitalised and have a low level of capital relative to the quantities of money it is handling[5]. It is sometimes located in an off shore tax haven and in other cases in the same host state as the originating company. The SPV will issue the bonds and pay the interest or other return on them and in due course be responsible for their repayment.

The source of the funds for this process will be from the income stream of the original company. This money from the originator is normally transferred to the second organisation to provide funds for payment of interest to the bond holders and in due course to repay their capital. This transfer will consist of the title to the income created by the underlying assets held by the originator being transferred from the originating company to the SPV. The originating company must engage in a "true sale" of the relevant assets, and it is necessary that this provides insulation for insolvency purposes so

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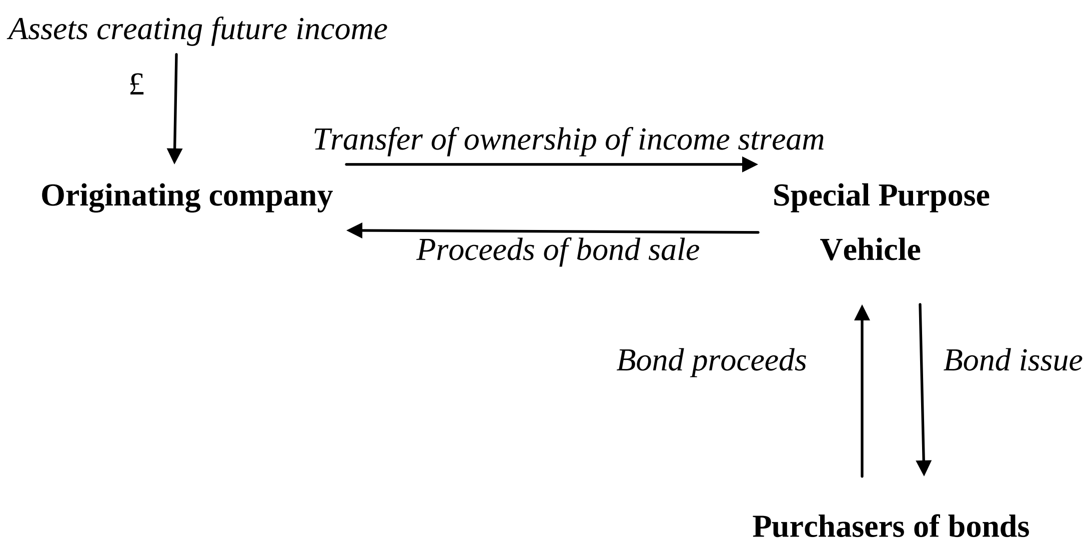
[1] Known as both "securitization" and "structured lending" in the United States
[2] Professor of Law at the University of Wolverhampton and Senior Visiting Research Fellow, Institute of Advanced Legal Studies, University of London.
[3] Attorney at Law, Markham, Ontario, Canada
[4] Kravitt J, (1996) "Securitisation of Financial Assets" Aspen Law & Business, p 11 and also Schwarcz "Structured Finance: a Guide to the Principles of Asset Securitization", Aspen Law & Business, p41.
[5] Slaughter and May "Model Guide to Securitisation Techniques." 2010. Pages 9 and 10

that in the event of the originator's insolvency its liquidator cannot unravel the arrangement and access the funds concerned for the benefit of the creditors generally[6].

Thus, at a simple level a traditional secondary securitisation looks essentially like this:

FIGURE 1



It is this asset backed form of securitisation that is examined in this article rather than an alternate which has developed more recently, known as whole business (or "synthetic") securitisation which involves the whole business or a segregated part of it utilising an SPV to raise funds. However, in this instance there is no transfer of title to the receivables to the SPV but a derivative arrangement, usually a credit default swap is used to structure the financial arrangement instead.

[6] The key statutory threats to a "true sale" under UK law are sections 178(1), 186(1), 238, 239 and 423 Insolvency Act 1986. In other jursidictions it will be the statutory equivalent.

For the purposes of convenience traditional asset backed structures will be referred to throughout this chapter as “securitisation”.

Islamic backgound

‘Islamic law’ itself is a generic term covering five main schools of Islamic thought[7]: the Shafi, Hanboli, Hanafi, Maliki and the Ibadi[8] and each has a slightly dissimilar approach to interpreting Islamic law. On some of the key issues in modern finance there are different positions found between them. In addition to this Islamic financial law involves two main methods of analytical thought; the critical and the constructionist. In essence, the former adopts a revisionistic approach to interpreting Islamic law and the latter constructs western style financial products which can operate within Islamic law. Critical theoreticians see the constructionist approach as an artificial method that distorts the role of Islamic law and interpret it as essentially nihilistic.[9] This article considers securitisation primarily from the vantage point of Islamic Shafi law as it is the main utiliser of Islamic securitization as will be seen from the figures relating to the scale of Malaysian activity in this area discussed at the end of the article..

All Shariah law forbids a return, reward or compensation charged in a transaction for the provision of a loan or in the rescheduling of a debt[10], and any positive, fixed,

[7] Four sunni and one shia, though if smaller Islamic sects are included there are a large number of sub groups. An exact number is a subjective issue as there are disagreements as to whether some sects are technically Moslem.

[8] El-Hawary D, Grais W and Iqbal Z, “Regulating Islamic Financial Institutions: the Nature of the Regulated.” World Bank Policy Research Paper 3227 (25th February 2004)

[9] Hamoudi, H.A. “Muhammad’s Social Justice or Islam Cant. Langdellianism and the Failure of Islamic Finance.” (2006) 40 Cornell International Law Journal, p3

[10] J. Michael Taylor, Islamic Banking – The Feasibility of Establishing an Islamic Bank in the United States, 40 Am. Bus. L.J. 385, 416 (2003). See also, Barbara L. Seniawski, Riba Today: Social Equity, The Economy, and Doing
Business Under Islamic Law, 39 Colum. J. Transnational L. 701, 707 (2001).

predetermined rate of return that are guaranteed regardless of the performance of an investment[11]. The relevant term for this is riba, which when translated, means an "increase" or "an addition" and denotes any increase or advantage obtained by the lender as a condition of the loan, or a fixed and guaranteed rate of return under a profit-sharing agreement. In its best known form, this prohibition disallows the earning or paying of any benefit, monetary or otherwise, on a loan of money, and is based in the principle that a loan should be characterised as a shared risk enterprise or charitable activity and not as a profit-making venture.

Notwithstanding that Islamic securitisation does not have a definition that is uniformly accepted or consistent amongst Islamic scholars, the concept underlying it is an adaptation of conventional securitisation in accordance with shariah law. In essence, Islamic securitisation involves using the cashflow, creditworthiness and collateral of tangible halal assets to support an offering of Islamic bonds (sukuk), all in accordance with generally accepted principles of shariah law. Clearly this raises serious issues as the lenders (the buyers of the securitised sukuk) would not normally have a direct exposure to the underlying assets of the originating company but receive a return in lieu of interest and repayment by the SPV which in turn owns the income stream transferred to them by the originator, which in turn still owns the underlying assets. Thus, the possibility of an adapted form of securitisation to satisfy Islamic law has to be considered. In practice though matters are not so straightforward. The return on Islamic bonds, though described in many cases as a dividend return is normally expressed as a fixed percentage[12]. Such

[11] Iqbal, Munawar and Abbas Mirakhor, An Introduction to Islamic Finance – Theory and Practice, Wiley Finance Editions, John Wiley & Sons, Inc., Hoboken/NJ, (2006).
[12] Kamali MH and Abdullah AK "Islamic Finance: Issues in Sukuk and Proposals for Reform" p2. International Institute of Advanced Islamic Studies, Kuala Lumpur 2014

bonds are referred to as 'sukuk' which translates as an 'Islamic investment certificate' and this term is used throughout the rest of this article.[13]

There is a general agreement between the various Islamic schools on seven key issues[14] that are banned: interest, excessive uncertainty, gaming, transactions in an unauthorized subject matter, restructuring debts on a compensatory basis, trading discounted debt, and forward rate agreements in currencies. The first two of these obviously raise key issues in the context of securitisation and are considered below. In addition two more (gaming and forward rate agreements) are relevant in the context of utilising derivatives to hedge currency risk. How Islamic securitisation can be structured in the light of this will now be considered.

Profit-sharing Agreement: Musharaka Structure[15]

Musharakah translates as "sharing" and in the commercial context relevant to securitization it means a shariah compliant joint enterprise in which all the partners agree to share the profit or loss of the joint venture[16]. The musharakah agreement is akin to a

[13] Thomas A, Cox S and Kraty B ""Structuring Islamic Finance Transactions." Euromoney, 2005. P 154. See also Lablou MS and Tanega J "Islamic Securitisation Part II – A proposal for International Standards, Legal Guidelines and Structures." JIBLR [2007] at p 366.
[14] Tariq A.A. "Managing Financial Risks of Sukuk Structures." http://kantakji.com/media/7829/f216.pdf
[15] Also known as "sharikah" structures
[16] See AAOIFI Shariah Standards at No 12, 3.6 See also 5/1/5/6. The AAOIFI is The AAOIFI is an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and shariah standards for Islamic financial institutions. The AAOIFI was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on February 26, 1990. Its requirements are mandatory for Islamic institutions in Brunei, Dubai, France, Jordan, Kuwait, Lebanon, Saudi Arabia, Qatar, South Africa, UAE and the United Kingdom. They are mandatory generally in Bahrain, Oman, Pakistan, the Sudan and Syria

conventional partnership arrangement[17] where each party contributes capital in their capacity as partners and each partner has management rights in proportion to their investment. However, the distinguishing feature of the musharakah agreement is that the share of profit for each partner is determined as a proportion of the final total profit rather than a ratio of the invested capital. The proportion of profit to be distributed between the partners must be agreed upon at the time the agreement is executed. If no such proportion has been determined and documented, the contract is not valid under shariah law. The lump sum amount or a certain percentage of the investment that has been agreed to must be expressly stated in the musharakah agreement and such provision will be subject to a final settlement so that any amount so drawn by any partner shall be treated as an "on account payment" and factored into the equation when determining the partner's share of profit. If no profit is earned or is less than anticipated, any amount drawn by the partner has to be adjusted accordingly.

Every partner in a musharakah agreement has a right to take part in its management. However, a provision may be added whereby one partner agrees to undertake the management duties whilst the others agree to become sleeping partners. In such cases, the sleeping partners shall be entitled to the profit only to the extent of their respective investment, and the allocation of profit should not exceed the ratio of investment. This is relevant in the context of Islamic securitisation where the investors, ie, the sukuk holders, will not be taking part in the running of the business.

[17] See for example s. 1 Partnership Act 1890 in England and Wales.

Applying this in the context of securitization, Musharakah sukuk are defined by the Accounting and Auditing Organization for Islamic Financial Institutions Standard (AAOIFI) [18] as:

"…certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any partnership contracts so that the certificate holders become the owners of the project or assets of the activity as per their respective shares, with the Musharakah certificates being managed on the basis of participation or Mudarabah[19] or an investment agency."

This is not an ideal definition as it potentially blurs the distinction between musharakah and mudarabah and the cross referencing is unnecessary given the fact that the arrangement traditionally includes the right for the partners to exercise management rights in proportion to their investment.

The structure of the musharakah sukuk will differ depending on the terms of the partnership agreement, and the nature of the project, but in many ways they are akin to mudarabah sukuk (see below). One version of the issuance is where a party enters into a musharakah agreement with a SPV, the equity of which is purchased by investors buying participation certificates, in this instance the sukuk. Each certificate represents proportionate ownership in the assets of the venture or project for which financing is being raised. Each partner then contributes capital into the musharakah – the originating

[18] AAOIFI Shariah Standard No 14 at 5/1/5/6
[19] A type of shariah compliant partnership arrangement (see below).

company contributes tangible assets such as land or property, and the SPV contributes the proceeds of the sukuk issue. The non-SPV partner is appointed the manager of the project in exchange for a management fee. The partnership then undertakes the project and profit is divided amongst the partners as it is realized; either upon completion of the project in the case of a construction project, or periodically if the project creates a stream of income.

A variation of this is where a diminishing musharakah agreement forms the basis of the offering – typically used if the venture will create a stream of income and one partner intends to purchase the other's interest over a period of time. Here, one partner; normally the SPV, elects to exercise its option to purchase the other's share in the project. As payments are received, the purchasing partner pays the selling partner an amount calculated as being the purchase price of the selling partner's share, divided into units and paid according to a payment schedule. This has potential for use in an Islamic securitsation where for example residential mortgage receivables are being financed, especially in jurisdictions which adopt shariah law[20]. However, there are problems because firstly, the holders of the sukuk will not be acquiring an interest in the underlying assets of the originating business but in the income stream from the originator to the SPV and thus potentially not be the "….owners of the project or assets of the activity…."[21] Secondly, the quasi-partnership structure will not suit a lot of companies seeking to structure a finance raising arrangement.

[20] McMillen MJT "Sukuk and Commercial Moratge – Backed Securities" at conference "Structuring Shariah Compliant Financial Instruments." London 8 July 2008.
[21] AAOIFI Shariah Standard No 14 at 5/1/5/6

Mudarabah structures

A mudarabah partnership is an agreement between two or more partners, each of which either contributes capital or investment know-how. The partnership agreement may specify a particular business or industry in which the originator wants the investor to invest its capital in[22]. If there is such a restriction it is called a restricted mudarabah[23] and the agreement may be silent on this point in which case the agreement is called an unrestricted mudarabah[24]. A prerequisite to the validity of a mudarabah partnership agreement is the correct determination of profit distribution. As with musharakah structures the partners must distribute any or all profit in accordance with a ratio or percentage of the actual profit realized, rather than based on their respective contributions.

Thus, whereas under a musharakah agreement the capital contribution is made by all partners whereas under a mudarabah agreement, the investment is made solely by the partners who act in the capacity as providers of capital[25]. Under a musharakah agreement all partners have a right to participate in the management of the business venture whereas under a mudarabah agreement this right is given solely to the providers of know how[26]. Under a musharakah agreement all partners share the loss of the business venture to the

[22] Known as mugayda
[23] Known as Al-mudarabah al-muqayyadah
[24] Known as Al-mudarabah al-mutlaqah
[25] Known as Rabb-ul-mal
[26] In some respects this parallels the structure facilitated by the Limited Partnerships Act 1907

extent of the ratio of their investment whereas in mudarabah the loss, if any, is suffered solely by the provider of capital since the others[27] do not invest capital.

Finally, a partner's liability under a musharakah agreement is typically unlimited. Thus, if the liabilities of the partnership exceed its assets and goes in liquidation, all the liabilities shall be borne pro rata by all partners. However, if the partners have agreed that no partner shall incur any debt during the course of the partnership, any debt so incurred in breach of this restriction is borne by that debt incurring partner. Whereas, in the case of a mudarabah agreement the liability of the lender is limited to the capital contributed.

In the context of an Islamic securitisation the value of the arrangement arises where the originator does not already own the assets. The sukuk holders would provide the finance to the SPV and it would then be passed on to the originator who would invest it according to the pre-existing agreement. The originator in turn would transfer the legal title to the resulting income back to the SPV and the sukuk holders would in due course share in any profits.

The AAOIFI Standards define the arrangement as: "certificates that represent projects or activities managed on the basis of Mudarabah by appointing one of the partners or another person as the Mudarib (the party using the capital) for the management of the operation[28]". These have seen the highest rate of rejection amongst

[27] mudarib
[28] AAOIFI Shariah Standards at 12, 3/6/2. See also 5/1/5/7.

Islamic scholar compared with the other types discussed here[29] and are only found in a minority of securitisations.

Ijarah structure

An Ijarah is a fixed term lease and is traditionally used in one of two contexts. The relevant one is that in which ijarah is used relates to the owners of assets and properties, and means, literally, to transfer the ownership of a particular property to another person in exchange for rent and in due course the residual value of the asset. It is generally used as a form of investment, and as a method to acquire finance.

In the context of securitisation the value of the assets should equal the value of the sukuk. However, such a structure would not satisfy the requirements of a traditional asset backed securitization structure, as the Ijarah structure would involve the originator selling the assets to an SPV and then having to lease them back. The SPV would use the leasing funds to finance the payments on the sukuk. In the event of default they will have contracted to buy the assets at a stated price. In reality such an arrangement is more akin to a leasing agreement under which a party pays rental payments to the other with the cash flow forming the basis upon which the sukuk are issued.

The relevant AAOIFI Standard[30] categorizes ijarah bonds as either certificates in leased assets, or certificates in usufructs of existing assets. They are defined as[31],

[29] McMillen at al, *supra*
[30] AAOIFI Issued Standard 17

"certificates that carry equal value and are issued either by the owner of a leased asset or an asset to be leased by promise, or by his financial agent, the aim of which is to sell the asset and recover its value from subscription, in which case the holders of the certificates become owners of the assets….(and)….documents of equal value that are issued either by the owner of usufruct[32] of an existing asset or a financial intermediary acting on the owner's behalf, with the aim of leasing or subleasing this asset and receive rental from the revenue of subscription. In this case, the holders of the certificates become owners of the usufruct of the asset".

The process is that a party sells an asset, ie, the income stream from the lease (see figure 2). In practice, this type of transaction is typically structured in one of three ways. Firstly, the owner agrees to sell an asset (the income stream) which is leased to a third party directly to investors with or without a repurchase option; the owner issues sukuk to investors, each investor acquires all legal and beneficial rights to the income from the lease; the sukuk proceeds represent the purchase price; investors receive the return under the lease during a specified period; the investors exercise the repurchase option and the original owner repurchases the asset, including any residual lease, for an amount equal to the outstanding principal amount under the sukuk on the on the repurchase date. Secondly, it can be done with no repurchase option and the investors may continue to own the asset or may sell it to a third party. Thirdly, the securitisation can also be created in this way but with an Islamic bank substituted for the SPV.

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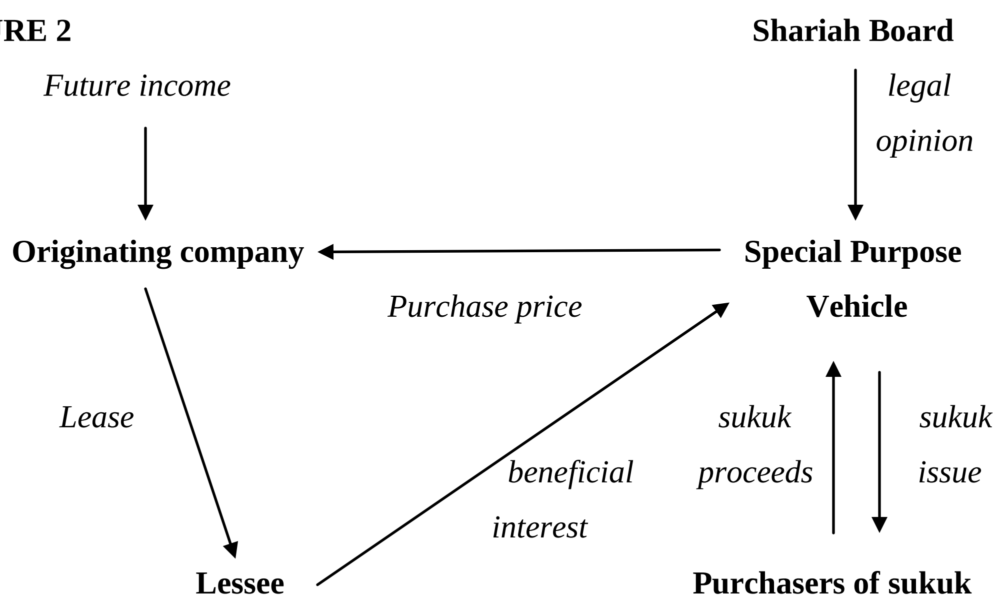
[31]AAOIFI Shariah Standard at No 17 Sections 3/2/1 and 3/2/2 respectively.

[32] This is a legal right *in rem* found primarily in civil law jurisdictions that unites the right to use something with the right to derive profit from it.

In addition, the owner of an existing asset can assign a beneficial interest in it to investors and/or a SPV acting as a financial intermediary. This type of transaction is typically structured in one of two ways, either an owner of an asset that is subject to a lease with a third party assigns a beneficial interest in the lease to the SPV; then the SPV issues the sukuk, the proceeds of which represent the purchase price of the beneficial interest; investors and the SPV receive the receivables under the lease during a specified period. Alternately, the owner of an asset that is not subject to a lease "head leases" the asset to the SPV which then issues sukuks, the proceeds of which represent the purchase price of the interest under the "head lease"; the owner sub-leases the asset from the SPV; then the investors receive the return under the sub-lease.

FIGURE 2



This can be a lease of assets to the SPV with a sale on dissolution to the originator or a lease rental with an exercise price on dissolution.[33]

[33] See IMF Working Paper, "The Economics of Islamic Finance and Securitization" May 2007

The sukuk are issued under a shariah compliant prospectus or a similar offering document which sets out the details of the mudarabah agreement, profit and loss distribution, the nature of the assets, payment terms and details regarding maturity of the sukuk and the termination of the agreement. The sukuk offering should not be supported by, nor should the prospectus or the offering document make reference to, any guarantee provided by the issuer unless it has been certified as shariah compliant by the relevant shariah board. Nor should the offering be made on the basis that investors will receive a guaranteed return. An Islamic bank typically acts as the arranger and underwriter of the sukuk, and its shariah board will approve by issuing a written fatwa before investors are permitted to purchase the sukuk. AAOIFI Shariah Standard provides some assistance here: "It is permissible in contracts of exchange such as contracts of sale or intellectual property but not in fiduciary contracts." Thus the availability of a guarantee will depend on the nature of the underlying contract[34].

Structures used to issue mudarabah bonds differ according to the nature of, and complexities involved in, the project that is being financed. In it simplest form, for example, to finance the construction of a building, the originator will issue an offering document to investors together with a mudarabah agreement. Once investors have accepted the investment opportunity and executed a copy of the agreement, a mudarabah partnership is established. This partnership then incorporates a project company and enters into a construction/project agreement with a developer. The sukuk proceeds fund the construction of the building either as lump sum paid upon its completion, or periodically in installments during the construction phase. Upon completion of the

[34] AAOIFI Shariah Standard No 5 at 2/1/1

building the developer delivers the building to the project company. In western legal terms this more closely replicates a secured loan than a traditional securitisation, so its usefulness in the context of the latter is limited.

This can be taken a step further[35] by creating lease pools. This could be done by the originator creating a pool of leases of items leased by that company and effectively engaging in a sale and leaseback of them, thus providing the originator with liquidity. However, in this instance the other members of the pool, who have thus effectively provided finance, are part owners. Ijarah tend to be most common in complex, multi-jurisdictional securitisations[36].

Salam structure

A salaam is a purchase and sale transaction whereby on the date of the agreement the purchaser pays the seller for an asset that is delivered by the seller on a future specified date to satisfy a current need. They are defined by the AAOIFI as "certificates of equal value issued for the purpose of mobilising salam capital so that goods can be delivered on the basis of salam to be owned by the certificate holders"[37]. The two fundamental requirements of a salaam transaction are that the purchase price must be paid in full on the date of the agreement and the purchased assets must be ascertainable in terms of its nature, quality or quantity and place of delivery. The payment must be for the full amount of the price, otherwise there will be a debt for the balance. The legal position

[35] Fogel and Hayes. "Islamic Law and Finance: Religion, Risk and Return." Kluwer Law International. London, 1998.
[36] McMillen at al, *supra*
[37] AAOIFI Shariah Standard at No 17, 3/3

would then be a partial or whole debt balanced against a debt, which is prohibited. Delivery must also be certain so the asset may not be one that might not be available to be delivered[38]. It is widely accepted across various schools of Islamic law. This has the potential to be used as part of a simple securitisation structure but does not seem to be heavily used in practice.

Wakalah structure

This is a type of agency arrangement where the agent is appointed for a specific task[39]. In the participatory mode this involves the party providing the finance (in the context of securitization, the sukuk holders) providing equity investment and sharing in the profits and losses. If carried out on a non-participatory basis the lenders provide finance for a specific purpose, eg, purchasing an asset and selling it on, hopefully for a profit. It can also be constructed in an accessory form where the agent acts on behalf of the buyer. It is not possible for the arrangement to guarantee a particular return as this will breach the tenets of many schools of Islamic law.

In the context of a securitised sukuk issue the originator sells the beneficial interest in assets to the sukuk holders and then manages the assets on their behalf, and in so doing has an obligation to the sukuk holders to maintain them. The arrangement is regarded as shariah complaint provided a minimum of one third of the portfolio in the form of fixed tangible assets or interests in land[40].

[38] AAOIFI Shariah Standard 2004, 5a 171. See also Zuhayli, 2003 1 p 263
[39] AAOIFI Shariah Standard at No 46
[40] Ali MI *supra* at p59

Murabahah structure

A murabahah[41] contract is a convenient method of financing the acquisition of an asset. In its simplest form, it is a transaction made possible by a series of contemporaneous agreements between an Islamic bank, the purchaser and seller of an asset pursuant to which the bank will contemporaneously purchase the asset from the seller and re-sell it to the client at a purchase price that includes a fixed amount of profit. This profit element of the purchase price is a fixed amount determined at the outset of the transaction by a top up being added on top of the purchase price by the seller. It thus operates as a type of deferred sale. The AAOIFI[42] define them as: "certificates of equal value issued for the purposes of financing the purchase of goods through murabahah so that the certificate holders become the owners of the murabahah commodity. It is an acceptable arrangement in Shafi based systems[43]. Examples of receivables that have been so used include marketing rights[44], bonds exchangeable for shares[45], rights derived from distribution licenses[46], and a mixture of lease income and the proceeds of selling air time[47]. To give validity to a murabahah agreement, the risk associated with ownership must lie with the Islamic bank during the period, however brief. The arrangement is widely used in corporate securitisation.

Given that, as discussed, there is inconsistency amongst Islamic jurisdictions and scholars with respect to the interpretation and application of shariah law, 'generally

[41] Derived from the Arabic word for 'profit'.
[42] AAOIFI Shariah Standard at No 17 at 3/5
[43] Ali MI "Sukuk: Perception, Innovation and Challenges" p 60 in Kamali MH and Abdullah AK ibid
[44] SABIC 2006
[45] Telekom Malaysia 2006
[46] Saudi Electricity Co 2007
[47] Etisalat of the UAE 2010

accepted principles' are those rules and interpretations expressly or by implication chosen by the parties to govern their agreements. Usually, this would be the version and interpretation of shariah law utilised in the jurisdiction most connected to the transaction. That in practice is usually the state of the originator, which is where any insolvency risk relating to the originator is likely to lie. Thus, it will be acceptance by the legal system of that country as to whether or not there has been a "true sale" of the assets concerned to the SPV that is crucial. It will also have been in that state that an Islamic scholar and the local Islamic Board of Banking Supervision will also have validated the scheme if it was to be put into effect. If this was done it is extremely difficult for a third party to challenge the validity of an arrangement.

Structuring a securitisation transaction in accordance with shariah law is a two-stage process. Firstly, the pool of assets that will potentially support the bond offering are scrutinised to determine whether they offend the Islamic prohibition by involving assets that are connected with what Islam considers as sinful activities; such as gambling, alcohol, lewd entertainment, or the sale of pork products amongst others. In strict Islamic jurisdictions[48], particularly, the more conservative ones, this is relatively easy given that activities such as gambling and alcohol are banned completely. However, in other jurisdictions this may not be as clear-cut in cases where the issuer of the sukuk has subsidiaries involved in, for example, cable television services, casinos, or fast food restaurants that sell and serve pork products where the banned element is a minor part of

[48] For example, jurisdictions which are, at least, members of the Organization of Islamic States (OIS) or the Islamic Development Bank (IDB). Most Islamic jurisdictions that are members of the OIS or IDB have legal systems at least partially influenced by shariah law (often combined, in the case of Egypt or Pakistan, with colonial European common contributions), or, in the case of conservative theocratic monarchies like Saudi Arabia, almost entirely guided by Islamic law.

the operation as a whole. Alternatively, an issuer with excessive debt, or one who directly or indirectly provides conventional financial services and charges interest would technically be barred from issuing interest bearing sukuk because of the prohibition[49]. However, in such cases payments to charity can be made of an amount equal to the profit on the part of the loan whose purposes are deemed un-islamic and this is taken as cleansing the prohibited element.

Similarly, the prohibition on uncertainty would prevent issuing bonds in connection with projects that are considered under shariah law to be overly speculative or risky, which technically would potentially bar issuers engaging in certain types of hedges, forward contracts, and contracts for differences; products which are commonly used in structured finance transactions in non-Islamic jurisdictions[50]. This would appear to debar a securitisation with an added derivative structure to hedge currency risk which would be useful where the sukuk are issued in a different currency from the originator's income. However, there is a way around this and it is discussed below.

Since shariah law forbids engaging in activities involving excessive risk, the offering document provided to investors must clearly set out the material terms of the lease so that investors can make an informed decision as to the creditworthiness of the bonds.

[49] Arial Berschadsky, Innovative Financial Services in the Middle East: Surmounting the Ban on Interest in Islamic Law, 9 U. Miami Bus. L. Rev. 107, 108 (2001).
[50] Babback Sabahi, Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for American Financial Institutions 1 (Boston Univ. Sch. of L., Working Paper No. 385, 2004).

Once a pool of assets has been isolated and approved as halal, the second stage involves ensuring the sukuk offering itself is halal, including the underwriting, standards, issue placement and the procurement of ratings[51]. Sukuk offerings marketed at non-Islamic investors or in non-Islamic jurisdictions also need to comply with local laws of the relevant jurisdiction. Local laws dealing with bankruptcy, trusts (if relevant), corporations, prospectuses, securities, secured transactions, perfection of security and tax will all have an impact on the sukuk offering.

Under an Islamic securitisation transaction, investors share an exposure to the business risk associated with the asset pool, and each investor is compensated for such exposure with a share of the profits commensurate to the amount of exposure in lieu of a pre-determined interest payment. This significant disparity, when compared to conventional securitisation where investors invariably hold secured contingent claims to pre-determined interest and principal payments, is based on the notion that business relationships are formed to share the business risk and return in assets and transactions that are considered halal. A determinative factor of halal is the funding or production of real assets rather than investment in financial securities to create a cashflow, which according to shariah law amounts to speculative activity and is offensive to the prohibition on riba, particularly where the securities are interest-bearing debt or issued by an issuer or in a manner that offends the halal requirements.

Part 2 of this article goes on to consider the difference between a traditional asset-backed securitisation and an Islamic one; what the difference is between the structures

[51] Wilson, Rodney, Overview of the Sukuk Market, in: Adam, N. J. and A. Thomas (eds.) Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk, Euromoney Books, London (2004).

used; and how this affects the issue. Other key elements are: the choice of law and jurisdiction utilized; pricing models; the extent to which a secondary market can function for such bonds; credit enhancement and whether it is possible to develop an Islamic securitisation utilizing derivatives to facilitate hedging any currency risk between the originator's income and the currency of the bond issue.